

REDUCING LOAN LOSS RATES IN COMMUNITY DEVELOPMENT FINANCE INSTITUTIONS

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ABSTRACT: One of the barriers generally faced by micro businesses¹ in the UK is accessing credit from banks. One way of reducing these barriers is through the establishment of Community Development Finance Institutions (CDFIs). CDFIs in the UK are set-up primarily to provide business finance for viable projects especially in deprived communities, which cannot receive bank finance. This article argues that loan loss rates resulting from lending to micro businesses in deprived communities arise generally from inappropriate lending terms and programme design of loan products on the part of lenders, rather than inherent characteristics of borrowers.

By examining institutional factors that influence loan loss rates in CDFIs, the results show that specifically targeting ethnic minorities, offering business training and advice in addition to loans and the longer it takes to process a loan were associated with high loan loss rates in CDFIs. Whereas the longer the term of the loan and the more localised the operations of the CDFI were associated with low loan loss rates. We conclude that to lend to disadvantaged people running businesses in deprived areas, it is not enough to concentrate mainly on borrower characteristics, but also on the lending institutions' features and services, which should suit the disadvantaged borrower.

I. INTRODUCTION

The importance of micro businesses in the UK economy has received attention both from Government and researchers (Bank of England, 1998, 2000; Department of Trade and Industry, 1996, 1999; Storey, 1982, 1994). Micro businesses in deprived areas in particular, potentially face more difficulty in obtaining credit from the traditional banks than larger businesses (Bank of England, 2000) despite the fact that they have been identified as the key to the Government's regeneration and neighbourhood renewal agenda (Social Exclusion Unit, 2000).

In recent years, increasing attention has been given to alternative ways of providing financial services, particularly loans, to micro businesses in deprived areas that cannot receive bank finance. One of the alternatives supported by the Government (HM Treasury, 1999) and Bank of England (Bank of England, 2000) is the promotion of Community Development Finance. Community Development Finance refers to a wide spectrum of initiatives designed to help disadvantaged communities and promote economic regeneration by providing access to finance (www.CDFI.org.uk). The main aim of community development finance is to provide credit especially to micro businesses in deprived areas that cannot otherwise receive credit from the banks.

When lenders lend money, they do so because they judge that they will get their money back on an agreed future date. Thus, the reduction in the risk of a borrower not repaying a loan either on time or at all is paramount to very lender, and even more so for CDFIs who lend to businesses that are considered to be high risk. There are two

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basic reasons for the banks' unwillingness or inability to lend to deprived businesses: high transaction costs and high-perceived risks of borrowers not repaying the loan either on time or at all. The operations of CDFIs also involve high transaction costs, but how can CDFIs ensure that monies lent out to micro businesses that the banks consider too risky to lend to, would be repaid? The authors' hypothesise that to reduce the risks of loan loss; CDFIs need to look at the suitability of their products and institutional design to the borrowers' needs in addition to the borrowers characteristics.

Given the above, what institutional factors affect loan loss rates in CDFIs? What lending policies should managers of CDFIs adopt in order to reduce loan losses? These are important issues because an institution with high loan losses will not be able to repay the providers of the funds that they lend be they individual depositors, banks, non-governmental organisations or in-deed the government. The paper proceeds as follows: we begin by looking at the role of banks and CDFIs in financing micro businesses in deprived areas in the UK and reviewing literature on factors that affect the ability and willingness to repay a loan. Using regression analysis, we then determine what institutional factors affect the loan loss rate in CDFIs. The paper is concluded with a summary of the main results with some recommendations. Such a study is of prime importance as knowledge of the factors of high loan loss rates will allow greater control and ultimately determine the future of the industry. Future research will investigate borrower characteristics.

II. FINANCING ENTERPRISE IN DEPRIVED COMMUNITIES

Despite the fact that the UK is one of the largest economies in the world, a closer look at the inner city areas of London, Birmingham, Manchester, Glasgow and many other big cities reveals worrying levels of deprivation. Since the late 1970's, there has been an increase in the geographical concentration of poverty and a growing inequality between the rich and poor (Wilkinson, 1998). The Gini coefficient, which measures inequality in income distribution, rose from 0.20 in the 1960's to 0.337 in 1991² (Griffiths and Wall, 2001). This figure is higher than the European average of 0.288, but lower than that of the USA, which is 0.341. Disturbingly, Atkinson (1996) presenting data of changes in the Gini coefficient of different countries over time, notes that whereas inequality in the USA, Germany, France, Italy and Finland were steady or falling, the UK has actually experienced significant increases in inequality of over 40% between 1977 and 1991. Gottshalk and Smeeding (1997) have also confirmed this. Absolute poverty³ however has not fallen. In fact, in real terms 90% of Britons are indisputably better off than they were in 1979; the poorest 10% are roughly, where they were (The Economist, 1999). Therefore, in the UK, though fewer people live on less than the average national income (low absolute poverty), high income inequalities imply that people cannot do today what other people in the society do, which may result from a structural lack of opportunities (Bourguignon, 1999).

² The Gini coefficient ranges from 0 to 1 with a rise in the coefficient suggesting less inequality

³ Absolute poverty is defined as the situation where people live below the level of income necessary for people to buy the goods necessary to their survival.

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The Labour Government in the 1990s has championed the creation of an 'enterprise culture' in the UK which would help create opportunities especially for disadvantaged people through the provision of credit among other things such as education, skill training and information and communication training. Two main issues have brought forward the need for credit as a tool for improving opportunities for the disadvantaged in the UK. The first is the realisation that the inner cities are becoming degenerated and unemployment leading to a situation known as social exclusion⁴. Local businesses are closing down, as people tend to spend their incomes outside these areas. The second closely linked factor is the reduction of bank branches in these areas leaving the inhabitants without financial services making them financially excluded⁵. According to British Bankers Association (BBA) (2000) there was a 29% reduction in bank branches between 1989 and 1999. At the end of December 1999 there were just over 12,000 bank branches (excluding agencies, sub-branches and self-service branches) in the UK. Those who are most affected by these events include the low-income earners, the unemployed, low skilled people and those who come from ethnic minority backgrounds (OFT, 1999).

According to Copisarow (2000), the demutualization and mergers of commercial banks coupled with the effects of globalisation has created higher minimum thresholds of profitability for credit transactions to be deemed worthwhile. As a result, those who do not qualify for bank loans have substantially increased. This has stretched the public purse to the limit and has left the majority of the potential micro credit market in a no-man's-land: too rich to qualify for relief, too poor to qualify for mainstream credit. It is the potential for social and financial exclusion to lock the disadvantaged in a vicious cycle of poverty, increasing the dependency on the benefit system and resulting loss of human capital, which has prompted various Governments to look at ways of solving this problem. In its worst form, the combined effect of these two cancers can bring about hopelessness, dis-empowerment and low self-esteem. It must be noted here that poverty and exclusion occurs in both rural and urban areas. This paper however, will concentrate on urban poverty and exclusion.

(i) Financing enterprise in Deprived Communities: Role of Banks in the UK

Businesses in deprived communities can be divided into those who can access traditional bank finance – 'bankable businesses' and those who cannot – 'non-bankable businesses'. As at June 2000, the banks lent £1.51 billion in deprived communities in the UK. This is just under 4 per cent of the total UK wide lending to small businesses, which stands at about £39 billion. This is however only to the bankable businesses. For the non-bankable businesses, the lack of business experience and the lack of collateral and personal equity have been cited as some of the factors that mitigate against the raising of external finance from the banks. Others are the concentration in business sectors subject to higher failure rates; remoteness; small and localised markets; and high crime rates (Bank of England, 2000). These factors make micro businesses in deprived areas more costly to lend to and generally perceived to be more risky than other businesses not in deprived areas. The banks tend not to lend to such businesses often branding them as 'unbankable'.

⁴ Social exclusion is a shorthand term of what can happen when people or areas suffer from a combination of linked problems such as unemployment, poor skills, low income, poor housing, high crime environments, bad health, poverty and family breakdown (www.cabinet-office.gov.uk/seu/index/faqs.html)

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Despite the unwillingness and or inability of banks to lend to micro businesses in deprived areas, Parkhouse and Drury (1994) argue that banks are best placed to lend to micro businesses in deprived areas. This is because whereas the banks are not forced to lend to all businesses, businesses are forced to use at least some aspects of the formal finance system. They have to open bank accounts and need the money clearing mechanism, which is currently run by the major banks. Businesses need other financial services such as savings and a comprehensive financial system that takes care of all their business needs not just credit needs. The banks reduction in their branch system accentuates the problem as evidence shows that small businesses and especially those in deprived areas tend to use more cash and as such need branches.

Copisarow (2000) further argues that lending to micro business in deprived communities requires a specialised approach, thus supporting the establishment of alternative institutions such as CDFIs. She is quick to note that the banks should have an interest in supporting such institutions as the micro businesses represent the next generation of small business clients for the banks and an additional market for non-credit products. A partnership approach, which enables the banks and CDFIs to share information and experience, will be of benefit to both the banks and the CDFI industry.

Banks however, have not completely neglected 'non-bankable' businesses in deprived areas. The banks have recognised the importance of alternative institutions such as Community Development Finance Institutions (CDFIs) providing credit to those the banks do not lend to. Though banks may not directly lend to micro businesses in deprived areas, they run or contribute to a number of CDFIs providing over 20% of total funding and by providing bank staff as secondees to the institutions. In summary, the banks have an important role to play in the provision of credit to micro businesses in deprived areas. Though they are not likely to lend directly to micro businesses in deprived areas, they collaborate with CDFIs to facilitate lending. The effectiveness of this collaboration is an important area for future research.

(ii) Community Development Finance in the UK

There are about 35 established Institutions in the UK (Bank of England, 2000). The complex nature of the 'poor' or disadvantaged in the UK requires a range of models to deliver the appropriate financial services. Such models include credit unions, micro – credit funds, community loan funds, mutual-guarantee societies and social banks. Others have included the use of alternative currencies like the Local Exchange Trading Systems (LETS) (Rogaly et. al., 1999). Appendix 1 describes the various models of community finance Institutions operating in the UK.

A recent survey⁶ by the authors found that the age of CDFIs in the UK ranges from 2 years to 22 years, with the majority being established within the last 2 years. CDFIs usually operate a multi-legal structure, mainly combining a limited company and Industrial and Provident society or a charity. They are mostly urban based. The

⁶ Questionnaires were sent to a random sample of 25 institutions by the authors out of whom 16

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average number of current borrowers per CDFI is 139 and ranges between 14 and 700. The current number of borrowers is estimated to be between 4,800 and 8,400⁷.

The main objective of CDFIs in the UK is to create and preserve jobs and to provide access to financial services. The least important objectives are to empower women and to make profit. They generally provide only unsecured loans and obtain funding predominantly from the Government, banks, local authorities, companies and individuals. CDFIs do not only target individuals but also areas depending on the conditions attached to the funding obtained. They tend to employ a small number of staff, use less volunteers and part-time workers and tend to have a lower percentage of their staff with traditional banking experience.

CDFIs charge an average interest rate of 8.6 per cent. The interest rate ranges from 1.25 per cent to 25 per cent. This is lower than that charged by the high street banks indicating that contrary to the belief that the cost of finance is less of a problem to disadvantaged people that the cost, costs are perceived by CDFI as equally important. The loans are on average offered for 34 months with most institutions offering loans for 35 months. The shortest term of a loan is 12 months and the longest 48 months. It takes on average 20 days to process a loan from when it is applied for till it is granted. The number of days ranges from 7 days to 42 days. The average loan loss rate⁸ was 10.5 per cent with the majority of CDFIs recording a loan loss rate of 5 per cent. The loan loss rate ranged from 0 per cent to 26 per cent. Appendix 2 presents some of the descriptive statistics from the survey.

iii. Client selection and lending decisions

Banks typically design their credit analysis and client selection criteria relying predominantly on information on the borrower and their business. Credit analysis by the banks, according to Greenbaum (1994), looks at a borrower's past records and economic prospects to determine whether the borrower is likely to repay or not. Relevant areas covered during credit analysis include the character of the person, capital needed, collateral requirements, capacity or ability to repay and condition of the market. The result of the analyses is for banks to either increase interest rates or to distinguish between good and bad risk borrowers/businesses. Increases in interest rates may increase adverse selection and moral hazard problems that would reduce the profitability of the banks. Thus banks have resorted to picking the best clients basing their selection procedures on the characteristics of borrowers and their businesses arguing that they need to select the most profitable businesses because they are for-profit organisations and are accountable to their shareholder and depositors.

To facilitate consistency of approach in selecting clients, some banks are gradually using credit-scoring techniques as one of a range of tools used in selection clients (Bank of England, 2000). Credit scoring measures the statistical probability that credit will be satisfactorily repaid (Guide to credit scoring, 2000). It has been suggested that credit analysis Rouse (1991) and credit scoring, which predominantly uses the characteristics of the borrower, (Bank of England, 2000), might discriminate against micro firms and people living in deprived areas. This is because the poor and

⁷ This is a rough calculation multiplying the average 139 by the 35 identified by the New Economics Foundation and 139 by the 60 micro credit schemes supported by the banks. This does not include the Princes Trust, which has over 35,000 borrowers since 1986, as this will over estimate the findings.

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disadvantaged are less likely to pass the screening tests by the banks. While such lending practices can lead to financial exclusion, it does not have to. Exclusion will occur when the lender i.e the banks, do not provide services to suit those who do not pass the credit scoring procedure or credit analysis.

Are micro businesses in deprived areas high risks? Evidence from the developing world suggests otherwise. Micro finance, popularised by the Grameen Bank of Bangladesh, provides small business loans to poor people. Micro finance has proved that lending to poor people need not necessarily be risky and can result in high repayment rates. Specialised agencies lending to the poor like micro finance institutions take banking to the poor instead of the poor going to the bank. Copisarow (2000) outlines some of the needs of micro businesses. They include small loan amounts, minimal waiting time for the loan to be approved; reasonable interest rates which need not be below standard banking rates; but lower than that of moneylenders and immediate subsequent loans. Others are high probability of receiving the loan, opportunities to network and clearly pre-explained terms and conditions. She goes on to note that the banks fail on many of these points. If these needs are not met then borrowers may not be able to repay a loan. Thus, the cause of the loan not being repaid would be in part due to the lender.

As Stearns (1995) rightly points out, “ banks appear justified with a policy of not lending to small and micro entrepreneurs if specialised agencies (such as CDFIs) set up for that purpose cannot collect their loans”. This statement makes it imperative that CDFI examine what factors that affect their loan losses, especially the institutional factors, because it is in this area that their innovation can be most illustrated.

The next section reviews literature on the factors that affect loan loss, default rates and repayment rates among specialised institutions lending to the poor.

III. Factors affecting loan loss rates in lending to deprived communities

One of the key functions of every lending institution is the recovery of loans lent out. Several authors (Greenbaum, et al, 1991; Hoque 2000; Gupta, 1990) suggest that when a loan is not repaid it may be a result of the borrowers' unwillingness and or inability to repay. The unwillingness and or inability of a borrower to repay a loan however, is due to a combination of three factors:

- a) The inherent characteristics of borrowers and their businesses that makes it unlikely that the loan would be repaid;
- b) The characteristics of the lending institution and suitability of the loan product to the borrower which makes it unlikely that the loan would be repaid and
- c) External factors such as the economic, political and business environment in which the business venture of the borrower is in.

The first factor (borrower/business characteristics) relates directly to borrower and their businesses and how their characteristics influence the probability of loan loss. A focus on these characteristics puts the blame of loan loss on the borrower and implies that the ability and willingness to repay a loan is due mainly to the borrower and or business characteristics. On the other hand, the second factor (lender/institutional characteristics) relates to the lending institution. This view relates the ability and

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willingness to repay to the lending terms and conditions that the borrower faces. If the lending terms and conditions are not favourable to the borrower, the likelihood of loan loss will be high even if the borrower has a viable proposal. In this case, loan loss could be blamed on the lending institutions. It could also be argued that the inability of the borrower to repay the loan could be due to inadequate business skills and training, and hence the need for business training and advice for micro businesses especially operating in deprived areas. The third factor affects all borrowers whether they are unwilling or unable to repay the loan.

Various surveys have on institutions specialised in lending to those who cannot receive bank credit have showed that the loan performance i.e default rate, repayment rate or loan loss rate, are influenced by both borrower and lender characteristics.

The Association for Social Advancement (ASA) in Bangladesh has conducted research into the causes of loan loss in micro finance. 353 out of a total of 775 loanee group members and focus groups were analysed and 15 causal factors were identified. It categorised the factors into formal institutional, non-formal institutional, geo-environmental and marketing. The formal institutional category looked at institutional factors such as organisational policy, staff efficiency, selection process, group functioning and organisational culture and competition of other non-governmental organisations. The non-formal institutional factors included the borrower characteristics such as family issues and roles, financial status, utilisation of loans, ability to invest and behavioural patterns of group members. The geo-environmental category analysed geographical location and environmental degradation.

The results gave the percentage of respondents that agreed with any of the factors causing loan loss s. The most significant causes of loan loss were found in the view of the borrowers to be irregular attendance in the groups, influence of lean season and financial difficulties caused by taking more than one loan from another NGO. Less common causes of loan loss were found to be where there is more than one loanee member from a family, nature of utilisation of credit, lack of marketing facilities and credit ceilings. These results identified various factors that could cause high loan loss rates and looked at both borrower and institutional characteristics. The study however, has some limitations. It just gave the percentages of respondents that agree with a statement with no statistical analysis. The research had about 80% of the respondents agreeing with any particular cause. It also looked at only one institution. Though it had the advantage of a large sample, the results do not indicate any causal relationship or correlation between loan loss and the factors.

Sharma M. and M. Zellar (1997) looked at repayment performance in group-based credit programmes in Bangladesh. They examined repayment rates in traditional commercial banks in the rural sector and analysed delinquency rates among 128 groups belonging to three group-based NGO institutions. Delinquency, which was the dependent variable, was defined as the failure to meet repayment obligation at the date complete repayment was promised. Their model showed delinquency as a function of the loan size, community characteristics, group characteristics and lender characteristics. The results showed that high level of land ownership, the greater the diversity of land use, the greater the proportion of members of a group reporting agriculture as a main occupation and families with more children were related to low delinquency rates. Other factors that were negatively related to the delinquency rate

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were the proportion of females in the lending group, whether the group was initiated by an NGO and the distance from the village to the service centre.

The results indicated that group size; the loan size and the difference between the value of loan applied for and the actual loan amount received were positively related to the delinquency rate. Other positive factors were the proportion of group members that were related to each other and the presence of other informal mutual self-help and insurance groups in the village. Though the authors did not clearly state the lender characteristics, they came to some useful conclusions. They noted the importance of innovative institutional structures in lending to the poor. They showed that repayment rates in group-based institutions were superior to those of commercial banks in Bangladesh. They also concluded that the combination of lending services with a range of vocational, social, nutritional and entrepreneurial education was important. The evaluation of loan applications, they note, should not be based on traditional forms such as gender, age, children etc that biases selection process.

The research failed to look at other factors such as interest rates, monthly repayments and the term of the loan. It concentrated on only 3 institutions and therefore could not offer a detailed analysis of the institutional characteristics and the relation to delinquency or loan loss rates.

Low loan loss rates, however, are not a feature of all microfinance institutions. Sharma (1993), Desai and Mellor (1993) and Bratton (1986) report fluctuating loan loss rates in Nepal and Zimbabwe. Despite this fact, developed countries have adopted some of the special features of micro finance to lend to their poor and disadvantaged.

In the USA, Avery, R.B et al (2000), looked at the Community Reinvestment ACT (CRA) Special lending programmes to provide an understanding of the CRA special lending programmes and to provide new information on the nature of these programmes. It placed particular emphasis on their characteristics and how these characteristics relate to the performance (delinquency and loan loss rates) and profitability to the programmes, of the loans extended through them. They sent out 500 questionnaires of which 143 were returned. These 143 organisations had a total of 660 programmes. Unlike the ASA research mentioned earlier, this CRA research looked largely at only institutional factors. It looked at the size of the individual programmes, the size of the parent organisation, the age of the programme, reasons for establishing the programme and the target groups. Others factors ere the activities of third parties such as government, presence of subsidies and guarantees. Like the ASA research this uses a large number of variables and shows the percentage of programmes to describe the characteristics of the programmes without any detailed statistical analysis. Though this is useful in identifying variables, it however does not make a lot of analysis with the loan loss rate. The following points were made:

1. The opportunity for borrowers to qualify for loans under special features such as: lower down payments, acceptance of alternative measures of credit quality (rent and utility payments histories, in lieu of more reserve traditional requirements and higher debt –to- equity rations), suggest that these may lead to lower loan loss

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2. It also suggested that the age of the programme affects the loan loss rate. It notes that the near zero rate of most of the programmes could be due to the relative newness of the programmes.
3. Other factors that could reduce delinquency and loan loss rates include: more intensive screening of prospective borrowers, greater effort to work with delinquent borrowers and policies encouraging increased forbearance of such programmes. No examples of such policies were given.
4. Programmes of larger institutions had higher loan loss and delinquency rates than those of smaller institutions.

The studies presented above have identified some of the factors that affect loan loss rates. However only one has used any form of detailed analysis. There is no research on loan loss rates in the UK in institutions lending in deprived areas and this research will clearly fill an important gap in the research into micro finance especially in the developed world. This paper is also different from other research in that it concentrates solely on the institutional characteristics and uses robust statistical analysis to explain the effect of these characteristics on the institutional loan loss rates. The other studies have either looked at one institution and combined the borrower characteristics with the characteristics of the particular institution (ASA research) or have looked at many institutions but without any statistical inferences (CRA research). This research will thus be the first of its kind looking solely at institutional characteristics over a range of institutions providing finance for the disadvantaged in a developed country and their effects on loan loss rates. The paper recognises some limitations such as the small number of community finance institutions in the UK and the fact that the institutions are relatively young.

IV. METHODOLOGY AND EMPIRICAL ANALYSIS

(a) Data

In 1999, the New Economics Foundation (NEF) conducted a survey of all CDFIs in the UK and came out with 32 institutions⁹. The NEF list was chosen for my study because it includes all the micro credit models as defined by the CDFI structure, the micro credit providers of the ILO structure and involve institutions with various orientations and targeting a wide range of disadvantaged borrowers. As this paper concentrates on non-bank finance for businesses, it excludes the credit unions¹⁰, social banks¹¹ and mutual guarantee societies who predominantly provide personal credit. For the purposes of this study, these institutions will be termed community development finance institutions. This is because it is the term generally accepted by the Bank of England (2000) and the British Bankers Association. Questionnaires were sent to a random sample of 25 institutions by the author out of which 16 replied. This report provides the findings from the 16 institutions that replied. There is no clear evidence of non-response bias, but there is the possibility that those institutions that

⁹ This sample excluded the Princes Trust, which is the largest micro credit institution in the UK. This is because it is not included in any of the lists and including them would over estimate the findings due to its large size. Since 1986 over 35,000 people have started over 30,000 businesses with PYT (BoE, 1999).

¹⁰ There are some business credit unions but they operate under a different methodology and their analysis will better be studied separately.

did not reply had either closed down or had been renamed and re-launched. Though the results are by no means general, it sheds some light on some of their characteristics (see appendix 2).

(b) Econometric Specification

The dependent variable used in the paper is the loan loss rate (LLR). Actual rates were collected from the institutions. Stearns (1997) notes that there are over 20 different formulae for portfolio quality. Though CDFIs in the UK use a variety of these measures the loan loss rate was the most commonly used and was calculated as the amount written off divided by the total amount lent. A loan loss is usually written-off when there was no hope for the business to survive. There was no fixed time period after which a loan would be written-off and every case was dealt with individually. CDFI's however, may take a long time to write-off a loan to reflect their more social orientation. It must therefore be noted that the length of time it takes for a loan to be written off may skew the loan loss rates in favour of younger institutions. The different write-off policies pursued by the institutions can make comparisons difficult. The average loan loss rate was 10.5 per cent. The loan loss rate ranged from 0 per cent for most of the younger institutions to 26 per cent for the older institutions. The most frequent loan loss rate was 5 per cent. The CDFI industry is still young and high loan losses may be expected as scale is yet to be achieved. What is important is that it does not become a growing trend as the industry develops, as this will kill the industry. The figures presented here are the loan loss rates as at January 2002.

The loan loss function is defined as follows:

$$\text{LLR} = f [\text{lending terms (LT), institutional features (IF)}] \quad (1)$$

where lending terms (LT) refers to the interest rate (R), loan size (LSIZE), term of the loan (LTERM), the time it takes for an application to be assessed and granted (LPROS) and the type of loan (PTYPE). The institutional features (IF) refer to type of institution (TINST), age (AGE), legal status (LSTAT), coverage whether local, regional or national (COV), total net value of assets (ASSETS), provision of training and advice in conjunction with the loan by the same institution (TA), whether the CDFI particularly targeted ethnic minorities (TETHNIC) and whether it targeted women particularly (TWOMEN).

The ordinary least squared (OLS) method is used to study the dependence of the loan loss rate on the explanatory variables and to be able to estimate and predict the loan loss rate for a given value of any of the explanatory variables (Gujarati, 1995). A correlation matrix was first constructed to check for multi-collinearity, which can arise due to the possibility of closely related variables. The most significant variables were chosen using the backward elimination method¹². This method removes the effect of any multi-collinearity. A two-tailed hypothesis test at a 95% confidence interval is used to accept or reject hypotheses. The R-square is used to determine how well the sample fits the regression line or what percentage of the dependent variable is explained by the explanatory variables. The t-ratios are used to test the significance of the individual explanatory variables in determining the loan loss rate.

¹² Full details of this method can be found in SPSS for windows by Marija J Norusis and the SPSS inc,

V. PRESENTATION AND DISCUSSION OF RESULTS

Table 1 provides the significant OLS estimations of the loan loss rate equation (1). In this chapter, the explanatory variables are defined. The a-priori expectations in the form of hypotheses are presented and the results interpreted. Each hypothesis is marked with a positive or negative sign according to whether the variable is positively or negatively related to the loan loss rate. The a-priori expectations are then tested and discussed using the t-ratios and the estimated regression equation. The descriptive statistics are presented in appendix 3.

Table 1 *Determinants of loan loss rates of CDFIs in the UK*¹³

Factors	Coefficients	Standard error	T-ratio	Sig.
<i>Lending Terms</i>				
LTERM	29.007	6.310	-4.597	0.10
LMIN	3.086E-03	.001	4.328	.0121
LPROS	.222	0.52	4.244	0.13
<i>Institutional Features</i>				
TA	14.756	3.663	4.029	.013
COV	-14.609	2.869	-5.093	.007
TETHNIC	19.368	3.063	6.324	.003
TWOMEN	-15.098	4.318	-3.497	.025
AGE	-.550	.190	-2.882	.013

Dependent variable: DR R-square: .948 F-ratio: 9.194

(I) Lending Terms

These first set of results present the results of the lending terms in order of significance. The results are presented in upper part of table 1. The most significant factor is the term of the loan (LTERM), defined as how long the loan was taken out for. The term is usually arrived at through negotiations between the lender and the borrower. It was expected that the longer a loan be taken out for, the higher the possibility of it being written off. This is because micro businesses in deprived areas are faced with more uncertain market conditions and operates usually in high-risk markets (Bank of England, 2000). As a result the longer they owe money the less likely that they would be able to repay. The results show a negative relation, which does not support the hypothesis above. If however, the increase in the term of the loan leads to a reduction in the monthly payments, or if repayments are more frequent, say weekly as in the case of micro finance in the developing countries (Mosley, 1996), then loan loss rates will fall. The results suggest that this reduces the monthly payments to more affordable levels, thereby increasing affordability. Thus to reduce

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loan loss rates in lending to micro businesses in deprived areas, shorter loan terms should be put in place. The term of loan ranged from 10 to 36 months with an average of 34 months. Relating this to the mode of the ages which is 2 years, it is possible that most loans had not yet reached maturity and cannot be yet be classified as non recoverable, hence the negative relation between the term of loan and loan loss.

LMIN represents the minimum amount that CDFI's would lend. The results indicate that there is a positive relationship between the minimum loan amount and the loan loss rate. The minimum loan amount is set to reflect an amount below which it would not be feasible to lend. Thus, lending very small loans could lead to high loan losses. This result support the argument that loans are not always the best option for poor people and for at some level of poverty and for very small amounts, grants may be more appropriate. What this analysis fails to determine the critical lower limit that CDFIs should lend. From the findings, CDFIs need to have a lower limit which should be calculated carefully, so that it is not too high as to exclude the people it set out to serve, yet not too low as to attract people who may not be able to repay and may need grants.

LPROS refers to the processing time for the loan. The shorter the processing time, the better the chances of the business cash flow problems and hence resulting in lower the loan loss rate (Copisarow, 2000). One of the main criticisms of the banks is the long processing and paper work that goes into granting a loan to small businesses. The results indicate that a shorter loan processing time reduces loan loss. The average processing time is 24 days in CDFIs. This however hides a wide range from 7 days to 90 days. The short processing time may increase the confidence of the borrower, increasing the willingness to repay. It may also mean that a generally efficient institution is quick and gets loans repaid. CDFIs must thus find effective ways of reducing the processing time to be able to achieve lower loan loss rates.

The average interest rate (R) was 8.8% and ranged from 1.25% to 25% but was not significant in explaining loan loss rates. It is interesting that most CDFIs charged 5%¹⁴ lending rates, which are generally lower than that of the banks (14%). It was expected that the interest rates should be higher than that of the banks to reflect the higher risks involved in lending to micro businesses in deprived areas. The loan size (LSIZE), the loan type (LTYPE) whether secured or unsecured and the maximum loan size (LMAX) are not significant in explaining the loan loss rate in CDFIs in the UK.

(ii) Institutional Features

The most significant institutional feature is (TETHNIC) which refers to whether the CDFI particularly targets ethnic minorities. This factor is a dummy variable with 1 for particularly targeting ethnic minorities and 0 or otherwise. It is also the most significant factor amongst all the other factors in explaining loan loss rates. The results indicate that a general intension of an institution to lend to ethnic minorities increases loan loss. A possible explanation is that focus on one group may result in that group taking the service for granted, thereby reducing the willingness to repay. This result demonstrates that if repayment rates can be improved through institutional factors then ethnic minorities may not necessarily require any special attention than that given to white borrowers if they are not inherent bad payers. CDFIs need to focus

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on what unites this sector of micro businesses in deprived areas, that is the lack of access of finance from traditional sources and find effective ways of dealing with them as a group. To target ethnic minorities, there is the need for research to show that ethnic minority credit needs, not social needs, are significantly different from that of other micro businesses in the UK and from each other.

COV, the coverage of the CDFI refers to whether the CDFI offers its services locally, regionally or nationally. This factor is also a dummy variable with 1 for services provided locally and 0 for otherwise. It is expected that a more locally oriented service would reduce loan losses. This is because a locally oriented lender would be able to understand the special needs of the particular community. The results support the hypothesis that a more locally oriented CDFI will reduce its loan loss rate, by being able to gather the information necessary to make effective loan assessments. This is also evident in micro finance in the developing countries where the community is the focus of attention even though they may have a regional headquarters¹⁵.

TA refers to the whether the CDFI also offers training and advice in addition to loans. TA consists of business advice, training and planning and technical skills training. TA is also a dummy variable where 1 is for offering TA in addition to loans and 0 for otherwise. Though training and advice is generally believed to be important to micro businesses, training and advice need not be compulsory in order for a loan to be obtained and should be provided at reasonable costs to the borrower. There is also a debate as to whether TA and loans should be provided within the same institution. It is expected that putting the same services in the same organisation will bias the loan assessment process. Thus, the provision of both services by the same organisation will negatively affect the loan loss rate. The results support this view and CDFIs are encouraged to focus on their core function, the provision of loans. Most of the CDFIs depend on referrals from enterprise agencies. Further research is needed into how effective this arrangement is and whether it results in better quality proposals leading to lower loan losses.

TWOMEN was also a dummy variable referring to whether the institution particularly targets women 1 or otherwise 0. General evidence from micro finance especially from the developing world is that women make better borrowers. Large institutions like the Grameen bank of Bangladesh lend primarily to women. The results support this view that targeting women leads to a lower loan loss rate. There are few institutions targeting women in the UK.

The age of the institution (AGE) refers to how long the institution has been established. It is expected that the younger the institution the lower the loan loss rate. This is because younger institutions would have given out a smaller amount of loans and fewer loans would have reached maturity. The results showed a negative relationship indicating the reverse that as CDFIs grow older the loan loss rate reduces. Though this result is not expected, it could be explained that the older institutions have been able to understand the market better and have adopted ways, which have helped reduce their loan loss rate. It also indicates that there may be a problem of the dissemination of best practice amongst CDFIs in the UK resulting in younger CDFIs

¹⁵ Most large micro finance Institutions in the developing world, such as the Grameen Bank or Bancosol, though being national have a large network of lending groups in various communities where

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not learning from the mistakes of the older institutions. The average and median age is 9 years. The ages range from 2 to 26 years. This result also supports the call by the Birmingham Conference on CDFIs in 2001 for the establishment of a trade body that encourages best practice and dissemination of information amongst CDFIs.

The other institutional features considered were the total net assets of the institution, the number of borrowers and the target area that is whether the CDFI operated in the rural or urban area. Also considered is the legal status of the institution and the whether the institution was a micro credit institution or otherwise. These factors were not significant in explaining the loan loss rate. An analysis of the means and medians in appendix 2 however reveals some interesting facts about CDFIs in the UK. The estimated number of CDFI client as mentioned earlier is between 4800 and 8500. This small number indicates that CDFIs are yet to make their presence felt in the small businesses community especially businesses that cannot access finance from the banks.

Finally, some of the reasons why clients may not repay on time or at all which are given by the respondents include:

- Business idea does not work out
- Health – physical/mental
- Cash flow problems – trading results not in accordance with the projections contained in the initial business plan
- Usually as a result of difficulty or failure in their business. Occasionally as a result of fraud
- Lack of liquidity
- Not enough sales
- Under capitalisation

VI. SUMMARY OF FINDINGS

- 6.1 The institutional factors that affect loan losses in CDFIs can be divided into lending terms and institutional features.
- 6.2 The most significant factor is the term of the loan (LTERM), defined as how long the loan was taken out for. The longer the loan was taken for the lower the loan loss. Since most CDFIs were 2 years old and most loans were taken for an average of 3 years, it meant that most of the loans had not reached maturity, hence the low loan rates.
- 6.3 Lending very small loans could lead to high loan losses. CDFIs need to have a lower limit to the amounts they lend which should be calculated carefully, so that it is not too high as to exclude the people it set out to serve, yet not too low as to attract people who may not be able to repay and may need grants.
- 6.4 Short processing times for the loans to be granted were associated with lower loan loss rates. This is because micro businesses require quick access to credit,

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like most other businesses, but the ability of the lender to provide credit in a short time, means that it is able to collect the information to lend efficiently.

- 6.5 The general intension to lend to ethnic minorities was associated with high loan loss rates. This was the most significant variable.
- 6.6 This is because a locally oriented lender would be able to understand the special needs of the particular community. The results support the hypothesis that a more locally oriented CDFI will reduce its loan loss rate, by being able to gather the information necessary to make effective loan assessments.
- 6.7 The provision of training and advice together with the loan by the same organisation negatively affects the loan loss rate. CDFIs are thus encouraged to focus on their core function, the provision of loans.
- 6.8 Targeting women leads to a lower loan loss rate supporting the argument that women are better borrowers.

VII. CONCLUSIONS

Community Development Finance Institutions in the UK are a potential alternative to bank credit for micro businesses that cannot receive bank finance. CDFIs are essential to the Labour Government's social exclusion agenda and to the encouragement of an enterprise culture in the UK. Banks are not likely to lend directly to micro businesses in deprived areas, they usually collaborate with CDFIs to facilitate lending. The selection process used by banks adversely affects micro businesses because the basis of the selection is the borrowers characteristics and the business proposal. Lending to micro businesses in deprived areas requires a specialised approach. This specialised approach can be achieved if the lending institution looks at the services they provide.

For CDFIs to be able to achieve their objectives of supporting micro businesses, which will in turn create jobs, they need to be able to get back the loans they provide. We noted three factors that may affect the ability and willingness of a borrower repaying the loan and concluded that lender characteristics were as important as borrower characteristics.

The results showed the most significant lender characteristics that affect loan loss rates. CDFIs need to increase the terms of the loans, which should result in smaller loan instalments. They should not set too low a minimum loan size and should aim to reduce the time it takes to process a loan application. Training and advice should not be provided together with the loan by the same institutions and being local provides the best chances of reducing the loan loss rate. CDFIs should not particularly target any ethnic minority however; particular attention should be given to women, as women seem to be better borrowers. There is the need for older institutions to disseminate information to younger CDFIs and to identify benchmarks for the effective provision of CDFI services.

One of the key problems in the relationship between the banks and micro businesses is that while the micro businesses need to use the banks for other services other than just credit, such as savings, banks are not required to lend to them. How can micro businesses run successfully if they are refused some financial services? One of the main features in micro finance in the developing countries is the growing importance

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this law is necessary to protect borrowers and the institutions, ways must be found to offer appropriate savings facilities to poorer customers who are refused bank accounts. Banks should lend to bankable businesses, but they may still have an interest in participating in a public-private partnership to fund finance and training needs of micro businesses in deprived areas.

Finally, to effectively lend to small businesses especially in deprived communities, the lender, be it the bank or CDFIs must adopt their lending policies to fit the situation of this special group. Focussing on the institutional characteristics more than borrower characteristics can not only reduce loan loss rates, but also reduce financial exclusion. This in the long-term will help reduce the financial barriers to micro businesses in deprived areas in particular and small businesses in general.

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Appendix 1: Community Finance Models in the UK

Community Finance in the UK consists of six models.

Credit Unions

Credit Unions are not-for-profit, co-operative institutions for saving and borrowing whereby members with a common bond save in the form of shares, which are then re-lent to members. There are three types of common bond: the work place (employee credit unions); a locality (community CUs); or an association such as a church group (associational CUs). Some 220,000 people now benefit from the services of 530 credit unions in England, Scotland, and Wales; 152 credit unions serve a further two hundred thousand members in Northern Ireland, which has seen the fastest growth of credit unions. While primarily geared to personal finance, a few credit unions are beginning to provide loans for self-employment and micro-enterprise.

Alternative Currencies

Local Exchange Trading Systems (LETS) allow members in a local area to trade services and goods among each other, using a local currency rather than the national currency. The currency consists not of coins or notes, but of credits and debits which are recorded against members' accounts. There are now about 450 LETS in Britain, with an estimated membership of 40,000. 'Time money', recently introduced in Britain, is an alternative currency based on the exchange of time.

Micro-credit funds

Micro-credit funds make very small loans to micro-entrepreneurs, typically working as sole traders, or in business with family or friends. The Prince's Trust, which lends to unemployed youth, is the largest initiative in the UK providing micro-loans. Three initiatives to extend micro-loans, as well as some pooled savings, to women on low incomes or welfare are currently being developed. There are also draft proposals for a new national micro-credit initiative to serve existing micro-entrepreneurs, especially those just beyond the business start-up phase.

Community loan funds

Community loan funds serve community regeneration initiatives by making capital available. Such loan funds are usually charitable, but not exclusively so. In 1999 there were eleven community loan funds in the UK, with assets of over £74 million, about half available for loans (as opposed to equity); further loan funds are under development. Community loan funds have helped to lever in additional commercial investment (in ratios of up to 1:10), as well as subsidies.

Mutual-guarantee societies

Mutual Guarantee societies are formal associations of small and medium sized enterprises which pool their savings in banks, so that they can offer collective guarantees which help them to obtain bank loans and achieve better lending and deposit rates. Their aim is to enhance the members' growth and stability. Over the last four years, eight mutual-guarantee societies have developed in Britain.

Social Banks

Social Banks are for-profit financial-service providers dedicated, typically in their constitution, to social or environmental objectives. Triodos Bank is the largest of these in the UK, though still very small by mainstream banking standards. Unity Trust is a bank established with a focus on trade unions, which also lends to community initiatives. In the USA, mainstream banks have also established social and community development banking subsidiaries, largely to meet the requirements of community reinvestment legislation.

Adapted from Rogaly et., al (1999)

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Appendix 2: Some characteristics of CDFIs in the UK

Variable	Units	Mean	Minimum	Maximum
Age of Institution	Years	8 (2)	2	22
Average no. of days to process a loan from when applied for to when granted	Days	20 (21)	7	42
Average term of loans	Months	34 (36)	12	48
Loan loss rate	%	10.5385 (5)	0	26
Minimum loan size	£	1258.00 (5000)	0	5000
Interest rate	%	8.6 (5)	1.25	25
Maximum loan size	£	15,566.67 (10,000)	2000	50000
Average amount lent	£	6809.40 (3000)	1487.00	25000
Number of current borrowers		139	14	700

Note: The mode is given in parenthesis below the mean.